

directing accumulation and determines that the income is required to be currently distributed. It also rules that certain extraordinary dividends which the trustee in good faith allocated to corpus in 1954 were properly allocable to income. In 1958, the trustee, relying upon the court decision, files a claim for refund of the tax paid on behalf of the trust for the year 1954 and thereafter files a suit in the District Court. The claim is sustained by the court (except as to the tax on the extraordinary dividends) in 1959 after the expiration of the period of limitations upon deficiency assessments against the beneficiary for the year 1954. An adjustment is authorized with respect to the beneficiary's tax for the year 1954. The treatment of the distribution to the beneficiary of the extraordinary dividends shall be determined under subpart D of subchapter J.

(c) The application of paragraph (a)(2) of this section may be illustrated by the following example:

Example: Assume the same facts as in the example in paragraph (b) of this section, except that, instead of the trustee's filing a refund claim, the Commissioner, relying upon the decision of the State court, asserts a deficiency against the beneficiary for 1954. The deficiency is sustained by final decision of the Tax Court of the United States in 1959, after the expiration of the period for filing claim for refund on behalf of the trust for 1954. An adjustment is authorized with respect to the trust for the year 1954.

(d) The application of paragraph (a)(3) of this section may be illustrated by the following example:

Example: A trustee claimed in the trust return for 1954 for amounts paid to the beneficiary a deduction to the extent of distributable net income. This amount was included by the beneficiary in gross income in his return for 1954. In computing distributable net income the trustee had included short and long-term capital gains. In 1958, the Commissioner asserts a deficiency against the trust on the ground that the capital gains were not includible in distributable net income, and that, therefore, the gains were taxable to the trust, not the beneficiary. The deficiency is sustained by a final decision of the Tax Court in 1960, after the expiration of the period for filing claims for refund by the beneficiary for 1954. An adjustment is authorized with respect to the beneficiary's tax for the year 1954, based on the exclusion from 1954 gross income of the capital gains previously considered distributed by the trust under section 662.

(e) The application of paragraph (a)(4) of this section may be illustrated by the following example:

Example: Assume the same facts as in the example in paragraph (d) of this section, except that, instead of the Commissioner's asserting a deficiency, the beneficiary filed a refund claim for 1954 on the same ground. The claim is sustained by the court in 1960 after the expiration of the period of limitations upon deficiency assessments against the trust for 1954. An adjustment is authorized with respect to the trust for the year 1954.

[T.D. 6500, 25 FR 12034, Nov. 26, 1960]

§ 1.1312-6 Correlative deductions and credits for certain related corporations.

(a) Paragraph (6) of section 1312 applies if the determination allows or disallows a deduction (including a credit) to a corporation, and if a correlative deduction or credit has been erroneously allowed, omitted, or disallowed in respect of a related taxpayer described in section 1313(c)(7).

(b) The application of paragraph (a) of this section may be illustrated by the following examples:

Example 1. X Corporation is a wholly-owned subsidiary of Y Corporation. In 1955, X Corporation paid \$5,000 to Y Corporation and claimed an interest deduction for this amount in its return for 1955. Y Corporation included this amount in its gross income for 1955. In 1958, the Commissioner asserted a deficiency against X Corporation for 1955, contending that the deduction for interest paid should be disallowed on the ground that the payment was in reality the payment of a dividend to Y Corporation. X Corporation contested the deficiency, and ultimately in June 1959, a final decision of the Tax Court sustained the Commissioner. Since the amount of the payment is a dividend, Y Corporation should have been allowed for 1955 the corporate dividends-received deduction under section 243 with respect to such payment. However, the Tax Court's decision sustaining the deficiency against X Corporation occurred after the expiration of the period for filing claim for refund by Y Corporation for 1955. An adjustment is authorized with respect to Y Corporation for 1955.

Example 2. Assume the same facts as in example (1) except that, instead of the Commissioner asserting a deficiency against X Corporation for 1955, Y Corporation filed a claim for refund in 1958, alleging that the payment received in 1955 from X Corporation was in reality a dividend to which the corporate dividends-received deduction (section 243) applies. The Commissioner denied the claim, and ultimately in June 1959, the district court, in a final decision, sustained Y

Corporation. Since the amount of the payment is a dividend, X Corporation should not have been allowed an interest deduction for the amount paid to Y Corporation. However, the district court's decision sustaining the claim for refund occurred after the expiration of the period of limitations for assessing a deficiency against X Corporation for the year 1955. An adjustment is authorized with respect to X Corporation's tax for 1955.

[T.D. 6617, 27 FR 10823, Nov. 7, 1962]

§ 1.1312-7 Basis of property after erroneous treatment of a prior transaction.

(a) Paragraph (7) of section 1312 applies if the determination establishes the basis of property, and there occurred one of the following types of errors in respect of a prior transaction upon which such basis depends, or in respect of a prior transaction which was erroneously treated as affecting such basis:

(1) An erroneous inclusion in, or omission from, gross income, or

(2) An erroneous recognition or nonrecognition of gain or loss, or

(3) An erroneous deduction of an item properly chargeable to capital account or an erroneous charge to capital account of an item properly deductible.

(b) For this section to apply, the taxpayer with respect to whom the erroneous treatment occurred must be:

(1) The taxpayer with respect to whom the determination is made, or

(2) A taxpayer who acquired title to the property in the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title in such a manner that he will have a basis ascertained by reference to the basis in the hands of the taxpayer who acquired title to the property in the erroneously treated transaction, or

(3) A taxpayer who had title to the property at the time of the erroneously treated transaction and from whom, mediately or immediately, the taxpayer with respect to whom the determination is made derived title, if the basis of the property in the hands of the taxpayer with respect to whom the determination is made is determined under section 1015(a) (relating to the basis of property acquired by gift).

No adjustment is authorized with respect to the transferor of the property in a transaction upon which the basis of the property depends, when the determination is with respect to the original transferee or a subsequent transferee of such original transferee.

(c) The application of this section may be illustrated by the following examples:

Example 1. In 1949 taxpayer A transferred property which had cost him \$5,000 to the X Corporation in exchange for an original issue of shares of its stock having a fair market value of \$10,000. In his return for 1949 taxpayer A treated the exchange as one in which the gain or loss was not recognizable:

(i) In 1955 the X Corporation maintains that the gain should have been recognized in the exchange in 1949 and therefore the property it received had a \$10,000 basis for depreciation. Its position is adopted in a closing agreement. No adjustment is authorized with respect to the tax of the X Corporation for 1949, as none of the three types of errors specified in paragraph (a) of this section occurred with respect to the X Corporation in the treatment of the exchange in 1949. Moreover, no adjustment is authorized with respect to taxpayer A, as he is not within any of the three classes of taxpayers described in paragraph (b) of this section.

(ii) In 1953 taxpayer A sells the stock which he received in 1949 and maintains that, as gain should have been recognized in the exchange in 1949, the basis for computing the profit on the sale is \$10,000. His position is confirmed in a closing agreement executed in 1955. An adjustment is authorized with respect to his tax for the year 1949 as the basis for computing the gain on the sale depends upon the transaction in 1949, and in respect of that transaction there was an erroneous nonrecognition of gain to taxpayer A, the taxpayer with respect to whom the determination is made.

Example 2. In 1950 taxpayer A was the owner of 10 shares of the common stock of the Z Corporation which had a basis of \$1,500. In that year he received as a dividend thereon 10 shares of the preferred stock of the same corporation having a fair market value of \$1,000. On his books, entries were made reducing the basis of the common stock by allocating \$500 of the basis to the preferred stock, and on his return for 1950 he did not include the dividend in gross income.

(i) In 1951 taxpayer A made a gift of the preferred stock of the Z Corporation to taxpayer B, an unrelated individual. Taxpayer B sold the stock in 1953 and on his return for that year he reported the sale and claimed a basis of \$1,000, contending that the dividend of preferred stock was taxable to A in 1950 at its fair market value of \$1,000. The basis of